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No. 2580

IN THE

United States Circuit Court of Appeals

For the Ninth Circuit

J. W. RAPPLE,

Appellant,

vs.

HARRY A. DUTTON, as Trustee of the Estate of LENNIG ENGINEERING Co., Bankrupt,

Appellee.

BRIEF FOR APPELLANT.

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I.

Statement of the Case.

The issue here is presented by an appeal from and petition to revise the order of the District Court made in a controversy between the appellant, Rapple, and the trustee in bankruptcy concerning the disposition of a certain fund in the custody of the trustee. The facts were stipulated as follows:

Prior to December 30, 1910, Lennig-Rapple Engineering Co. was a copartnership consisting of J. W. Rapple and E. B. Lennig. Its assets were

chiefly contracts for work and material; among them were two with the City and County of San Francisco, one on the Hall of Justice and the other on the County Jail. The performance of the latter was secured by a bond executed by United States Fidelity & Guaranty Co., hereinafter called the Guaranty Co. Upon said date forty per cent of this contract had been performed. The partnership was then dissolved, Rapple retiring and Lennig continuing to transact the business. By the agreement of dissolution, Rapple transferred to Lennig his interest in the firm assets, including said contracts, and Lennig assumed the firm debts, paying Rapple $6000 in cash, and giving him a note for $2800. Lennig thereafter continued in the performance of these contracts, doing about fifteen per cent of the work on the County Jail, until August 5, 1911, when he procured the incorporation of Lennig Engineering Co., hereinafter called the corporation. He transferred his interest in the former partnership assets to the corporation and procured it to issue to him all of its capital stock except four shares used to qualify dummy directors. Lennig remained at all times the owner of the stock and the only person actually interested in the corporation. The corporation took these assets with full knowledge of all the facts.

The corporation thereupon performed fifteen per cent of the work on the County Jail and then defaulted, so that the Guaranty Co., as surety upon the contract, undertook to complete it and did so on

October 12, 1912, having performed the remaining thirty per cent of the work. After paying out of the contract price for all materials and labor used, it had on hand a balance of $783.44. The corporation had meantime become a bankrupt.

On said October 30, 1912, Rapple and the corporation's trustee in bankruptcy both made demand upon the Guaranty Co. concerning this fund. The trustee claimed it as an asset of the bankrupt; Rapple's claim was based upon the following facts: A portion of the contract of the partnership on the Hall of Justice had been sublet by it to Asbestos Manufacturing & Supply Co., hereinafter called the Supply Co. The latter furnished labor and material for the price of $999.78, for which it had not been paid. It sued the partnership under the firm name and on October 24, 1912, recovered a judgment against it. Rapple asked that the profit made on one of the former partnership contracts should be used to pay the loss suffered in the other, for which he was personally liable.

A hearing upon the subject was had before the referee, who, on September 4, 1913, directed the Guaranty Co. to pay the fund to the trustee without prejudice to Rapple's claim. Directly the money was in the hands of the officer of the court, Rapple petitioned that it be used to pay the claim of the Supply Co. on file in the bankruptcy proceeding. The petition was denied, and on review in the District Court the order of the referee was affirmed.

The jurisdiction of this court is invoked by appeal from, and petition to revise, said order, which, appellant contends, was erroneous in that it, in effect, denied the relief sought.

II.

Brief of Argument.

The gist of this case is the retiring partner's equity invoked in respect to a firm asset which is in the custody of the court. The fundamental principle has been incorporated in the Civil Code of California:

> "Sec. 2405. Each member of a partnership may require its property to be applied to the discharge of its debts, and has a lien upon the shares of the other partners for this purpose, and for the payment of the general balance if any due to him."

The contract upon the County Jail was an asset of the partnership. By reason of Lennig's agreement upon dissolution to pay the firm debts, this asset continued to be subject to the equity or lien of Rapple which attached as well to the profit which the contract had the capacity to produce. Lennig failed to pay the debts; in a suit against the partnership the Supply Co. recovered a judgment, upon which Rapple is, of course, personally liable. He is entitled, therefore, to invoke his equity in the asset in the hands of the court, and to compel its application upon the partnership debt.

Lennig's transfer to the corporation does not alter the situation, because it was not a *bona fide* purchaser, but was merely a form under which Lennig did business. Rapple's equity therefore prevailed.

The principle of equity upon which we rely is well established in the authorities. In *Conroy v. Woods,* 13 Cal. 626, a partnership was dissolved, two members selling the assets to a third, who agreed to pay the debts. The court held:

> "It has been seen that Bonny bought out the other two partners and agreed to pay the firm debts. * * * Bonny then held the firm assets; and the question is, having got the title to them in this way, whether they stood anywise differently as respects the firm creditors than if the firm had continued? If the firm had continued, it is not disputed that the rights of the firm creditors would have been prior and paramount to those of an individual creditor; and it is not easy to see any substantial difference in respect to the principle we are considering, between one partner's buying out his associate's share on agreement to pay the debts of the firm, and suffering the firm name to continue. This was partnership property bound for partnership debts when the firm was in existence, and it continued to be bound for those debts after the sale to this partner, especially when he assumed, as a part of the transaction, of purchase, the payment of those debts" (p. 631).

In *Allen v. Cooley*, 31 S. E. 634 (S. C.), the facts were stated by the court as follows:

> "By the terms of the dissolution the plaintiff agreed to receive, and did receive, in full of his interest, a tract of land estimated at $3500, and

> two notes of D. K. Cooley, indorsed by T. D. Cooley, for $790 each, * * * one payable on 1st of November, 1898, and the other payable on 1st of December, 1898; and all the other assets of the firm—real as well as personal—were turned over to the defendant D. K. Cooley, he agreeing to pay all the debts of the firm, and releasing plaintiff from any liability therefor" (p. 642).

The court held:

> "The partnership assets were left in the hands of D. K. Cooley, with an obligation on his part to apply the same to the payment of the partnership debts, in relief of the plaintiff, and are in fact impressed with a trust for that purpose. If so, then the plaintiff unquestionably would have a right in equity to take any suitable measures for the protection of that trust fund, and enforce its application for the purpose for which it was intended, so as to relieve himself from loss" (p. 645).

It was held that the retiring partner was entitled to the appointment of a receiver for the preservation of the former firm assets, notwithstanding that the continuing partner was not shown to be insolvent.

In *Buchan v. Sumner,* 2 Barb. Ch. 165, 197, the court states its decision in two earlier cases as follows:

> "That an assignment by one of the partners, or by his personal representatives, of his or their interest in the surplus, was not a relinquishment of the equitable claim to have the debts of the firm paid out of the copartnership funds, where the rights of bona fide purchasers were not involved."

The same principle is applied in *Tenney v. Johnson,* 43 N. H. 144; *Jones v. Newson,* Fed. Cas. No. 7484, and *Bulger v. Rosa,* 6 N. Y. Supp. 38.

In passing upon the situation presented by the dissolution of a partnership by the death of a member, the Supreme Court held, in *Shanks v. Klein,* 104 U. S. 18, 22, quoting from a Massachusetts decision:

> "Is not the share of each pledged to the other, and has not each an equitable lien on the estate, requiring that it shall be held and appropriated, first, to pay the joint debts, then to repay the partner who advanced the capital, before it shall be applied to the separate use of either of the partners?"

In *Holmes v. Baker & Hamilton,* 160 Fed. 922, the adjudication of a member of a dissolved partnership for an act of bankruptcy committed thereafter was attacked. This court held in affirmance:

> "The rule is well settled that, where assets or debts of a partnership remain after dissolution, the partnership is considered as subsisting as to its creditors until its property is subjected to the satisfaction of their claims."

The precise question was presented *In re Filmar,* 177 Fed. 170. There the partnership of Swigert & Filmar dissolved, the former selling his interest to his partner in consideration of a money payment and the latter's agreement to pay the firm debts. He continued in business for a time, paying all the creditors but Lippincott, and then was adjudicated a bankrupt. The property turned over to the

trustee had formerly belonged to the firm. The opinion states:

> "Thereupon Lippincott filed his petition, asking that his debt be paid from the assets ahead of the claims of Filmar's individual creditors; and Swigert filed a like petition, asking the same relief, without offering to repay the consideration he received on selling his interest to Filmar. The final decree dismissed these petitions for want of equity; and the petitioners have severally appealed."

The Court of Appeals for the Seventh Circuit held:

> "With the property in custody and all the parties present, and no rights of innocent purchasers or transferees having intervened, a court of general equity powers would concededly award priority to Lippincott, because there had been no application of the property, with the consent of the partners, to the payment of individual debts (Sargent v. Blake, 160 Fed. 57), because Lippincott in his own right as a partnership creditor would be entitled to equity's rule of distribution, and because Swigert for his own protection would have the right to ask that Lippincott be first paid."

The court then quotes from the Bankruptcy Act and proceeds:

> "These provisions, we think, indicate very clearly that Congress intended that the bankruptcy courts should have full equity powers in dealing with partnership matters. The particular objection here seems to arise from the fact that Swigert and the partnership were not before the court as bankrupts."

In overruling this objection the court held:

> "Under the various provisions of section 5, what procedure on Lippincott's part would have been necessary or possible in order to invoke the full equity powers of the bankruptcy court in case Swigert had not voluntarily appeared and filed his petition, we will not now inquire; for, with his appearance, the bankruptcy court had before it all parties in interest, and his petition was a consent that the partnership property be administered by that court in accordance with the equitable principles approved by Congress."

Aside from the factor that Lennig's corporation, and not Lennig himself, is the bankrupt here, the analogy between the case cited and the one at bar is perfect. The element of difference is not material. As the court for the Seventh Circuit held, the case was governed by principles of equity applied in the bankruptcy proceeding. We have already demonstrated that the retiring partner's equity in the former firm asset now in the custody of the court is the source of Rapple's right which was not destroyed by Lennig's transfer of the assets to the corporation, first, because the latter took with notice and, as the court pointed out in the *Filmar* case "no rights of innocent purchasers" have intervened and there has been "no application of the property, with the consent of the partners, to the payment of individual debts"; and, second, because the transfer to the corporation was no transfer at all, in that equity, piercing the veil of corporate entity, perceives the identity between Lennig and his corporation, thus circumventing the

fraud upon Rapple which would result if his rights were held divested by the incorporation. This doctrine has been applied, for example, in a case where a partnership and its two members had been adjudicated bankrupts. They had done business for some time in the name of a corporation organized by them in which they and their wives were the only stockholders. On demand by the referee, the bankrupts refused to produce the books of the corporation. The matter was certified to the district judge, who held:

> "The examination of the books should be allowed and made, so far as to ascertain what sums if any were owing to the Horgan and Slattery corporation at the time of the adjudication, because the circumstances already in evidence justify the court in treating the corporation as a mere fiction, and the sums due it as assets of the bankrupts."
>
> *In re Horgan*, 97 Fed. 319.

In *Colonial Trust Co. v. Monticello Works*, 172 Fed. 310, it was held:

> "While we recognize the legal principle that a corporation does not lose its entity by the ownership of the bulk or even the whole of its stock by another corporation, yet it is equally well settled, courts will look beyond the mere artificial personality which incorporation confers, and, if necessary to work out equitable ends, will ignore corporate forms" (p. 313).

This court held in *Exploration Co. v. Pacific Co.*, 177 Fed. 825:

> "The corporate entity cannot be so disguised that it can successfully masquerade in the name

> of a stockholder. * * * A court of equity looks through forms to the substance of things, thus preserving the rights of innocent parties against all deception and fraud'' (p. 839).

Where parties sold letters patent and then organized a corporation in which they owned all the stock, and which was made a defendant in an infringement suit, it was held in *Force v. Sawyer-Boss Co.*, 111 Fed. 902:

> ''The defendant corporation is estopped by this act of the persons who created, direct and own its capital stock, and are its sole directors and officers.''

Other cases of the identity of a corporation and the person who owns all of its stock are

> *Venner v. Farmers' Co.,* 90 Fed. 348, 356 (C. C. A. 6th Cir.);
>
> *In re Berkowitz,* 173 Fed. 1013.

Rapple's equity in the fund in the hands of the court is, therefore, paramount.

The case here should not be confused with that presented in a plenary proceeding brought by firm creditors, or their representative, after dissolution of the partnership to recover funds formerly belonging to it, which have been used by the continuing partner to pay his individual debt. In such a case, notwithstanding the promise of the continuing partner on dissolution to pay the debts, the creditors have no remedy, because the retiring partner has not asserted his equity and the former firm money or property is not in court but, on the con-

trary, is in the hands of a third party taking in good faith and for value. The retiring partner's equity is thus no longer effective. The creditors' right, derivative in character, is also lost; and it is only where the property is *in custodia legis* that the subject matter exists for an original application by creditors to have the firm assets marshalled. The case of *Sargent v. Blake,* cited in *Re Filmar,* is one of the class here distinguished. Another is *Case v. Beauregard,* 99 U. S. 119, an authority upon which the *Sargent* case is based. There the partners disposed of firm property in payment of the individual debt of one of them. It was held that a firm creditor could not by suit in equity vacate the transaction. In the course of the opinion, in discussing by way of *dictum* the effect of a transfer of partnership property it is said that the partner has an equity and not a specific lien for the payment of firm debts.

The distinction which we have pointed out is again very clearly defined in *Re Terens,* 175 Fed. 495. In respect to the decisions of the Supreme Court it is held:

> "It is strenuously insisted in argument that these authorities are decisive in the instant case. But it will be observed that in each of the cases cited certain of the firm assets had been sold by consent of all partners to third parties, so that a complete legal title to the specific items of personal property passed to the purchaser and amounted to a complete waiver of this equitable right, and constituted a release of such assets from firm liabilities. In

> the instant case there has been no such disposition. The status of the firm assets was precisely the same on the 12th of January that it was on the 15th of December. The only change wrought by the dissolution agreement was in the attitude of Oswald, who by virtue thereof became a surety for the firm obligations. Brandt on Suretyship and Guaranty, Sec. 36. I cannot see that this change in the legal attitude amounts to a waiver on the part of Oswald which would defeat the equity of the firm creditors" (pp. 498-9).

The court goes further in that case than is necessary here; it gives a preference to the firm creditor although no application is made therefor by the retired partner. Both members were insolvent at dissolution; but that this is not material is plain from the cases of *Case* and *Filmar.* The decision is no doubt correct, because the court was called upon to administer a former firm asset. While not so deciding, the court in *Re Filmar* suggested that in a proper case relief might be given upon the application of the creditor.

Since a property right is involved here, the status of the firm asset and Rapple's equity in it is to be determined according to the law of California announced in *Conroy v. Woods* (supra). As the court held in *Re Scruggs,* 205 Fed. 673, 675, quoting in part:

> "And it is well settled that the trustee takes not as a bona fide purchaser for value, but as the bankrupt held the property, subject to all valid claims, liens and equities.

"The validity of such claims, liens and equities is to be determined in the absence of federal statutes by the local law as evidenced by the decisions of the state courts."

Thompson v. Fairbanks, 196 U. S. 516;

Knapp v. Milwaukee Trust Co., 216 U. S. 545.

Conroy v. Woods has never been questioned, and stands for the doctrine that the partner's equity survives after dissolution by reason of the continuing member's promise to pay the debts, and that a firm creditor may enforce this equity even though the asset is not *in custodia legis.* Although it is not necessary so to decide here, such are, no doubt, the legal principles which control in the case at bar.

Some point may be made upon the contents of the answer filed by the partnership in the action brought against it by the Supply Co. The dissolution was pleaded and issue of novation and acceptance of Lennig as the debtor in the place of the firm was raised. The judgment against the partnership was, of course, a finding against this defense. In any event, it is one of the stipulated facts that the Supply Co. is a creditor of the firm. This cannot be impugned.

It will be contended by the appellee that inasmuch as the partnership performed only forty per cent of the contract from which the profit accrued, Rapple's equity should under the maxim "equality is equity" be operative only upon forty per cent of the profit. But the right which is invoked here

attached to the entire contract, including any increment which it was capable of producing. The profit represents the excess of contract price over the cost of the materials and labor used in its performance; it stands now in the place of the contract; the contract was the potentiality—the profit the actuality. Equity will, therefore, require that it be used to pay the creditor of the partnership whose claim represents the loss suffered under the other partnership contract. Surely, such a proceeding is in full accord with the justice of the situation.

Dated, San Francisco,
May 10, 1915.

Respectfully submitted,

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